PROPOSALS FOR STRENGTHENING THE NATIONAL BANKING SYSTEM. III.

A CENTRAL BANK OF LIMITED SCOPE

SUMMARY

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I

The present paper will be concerned entirely with the elucidation of a plan for a central bank; but as the effectiveness of the plan would largely depend upon the adoption of the proposals which were brought forward in the two preceding articles in this series, these proposals may be summarized here by way of introduction.[1] The establishment of true savings departments by the national banks with segregated deposits payable at notice, which might be invested in mortgages, was advocated as a means of enabling the banks to employ more of their funds at home, thus reducing somewhat the strain upon the city banks in emergencies. Two classes of banks, local and reserve agent banks, were proposed to take the place of the present three classes. Both classes of

[1] See the issues of this Journal for February and August 1910.

banks might be established anywhere, but those choosing to become reserve agent banks would be required to have a minimum capital of $500,000 and would be obliged to carry a cash reserve of 25 per cent, a cash reserve of 10 per cent being required from local banks. In order to render more certain the use of reserves in emergencies it was suggested that the banks should be allowed to go below reserve requirements upon the payment of a fine sufficiently onerous to ensure the maintenance of reserves in normal times, but not so high as to prevent their use when really needed. An asset currency limited in amount to 40 per cent of the capital and surplus of the banks was proposed, to take the place of the bond-secured notes. This separation of the circulating medium from government bonds would enable the government to avoid the accumulation of a large surplus in the treasury in the future. Finally, it was pointed out that elasticity cannot be secured while the present practice of paying interest on bankers' deposits continues. The payment of interest upon minimum weekly or fortnightly balances during a period of six months was suggested as a way out of this unsatisfactory condition of affairs.

The adoption of these proposals would diminish materially in emergencies the strain upon the reserve-holding banks of the cities and would also increase somewhat and make more available the money holdings of the banks generally. But while the power to meet the demand for loans and also that for cash from depositors would be increased, it must be admitted that no absolute certainty is secured against that senseless scramble between the banks to strengthen themselves which more than anything else has caused the breakdown of our credit machinery on every

occasion of severe strain in the past. Bankers must have confidence in the means at their disposal, and the public must have unquestioned trust not only in the ultimate solvency of the banks but also in the ability of the banks to maintain payments at all times; otherwise, no system, however strong it may be, can endure the strain incidental to trade reaction without danger of financial panic.

Now, altho one may feel convinced that the means which have been suggested would be ample to enable the banks to handle emergencies effectively, it becomes evident that something more is needed when we find that the officers of our large reserve-holding city banks are of the opinion that, even with a very considerable increase in the ratio of their cash holdings to deposit liabilities, it would be impossible to respond to the demands which would be made upon them by country banks in a crisis of the severity of that of 1907. On the other hand, there is apparently a widespread and growing belief among bankers that difficulties which have proved overwhelming in the past can be met and even removed through the establishment of some kind of central bank or central authority in our banking system. It is urged, and with much reason, that the results achieved in all countries which have made trial of institutions of this kind would give it an initial prestige which would be a source of great strength. It is also pointed out that we should then have a banking influence exercised with a deep sense of responsibility, and above all that we should have a reserve of cash and of lending power which could certainly be turned to in emergencies.

The promise of improvement through the establishment of a central bank would seem to be bright if it is so devised as to fit into our existing complex

banking machinery. This possibility does not, however, lessen the importance of proposals designed to strengthen the existing banks such as those with which the preceding articles have been concerned. On the contrary their importance is rather enhanced if the attainment of the desired results is to be secured through the device of a central bank. The danger that other banks will rely wholly upon it for assistance in emergencies is one which must be squarely faced. The restraining power which a central institution can exercise in periods of business activity over twenty thousand or more independent local banks is certainly slight, far less than that over the comparatively small number of banks in European countries in which branch banking prevails. Influenced by the natural desire for large profits, our banks have shown no evidence of any appreciable willingness to maintain themselves in a stronger condition than was required by law. It is to be feared that the mere existence of a central bank will tend to foster the growth of unsound conditions by relieving the other banks of all sense of responsibility. Moreover, should the entire burden in emergencies be imposed upon the central bank, its power to make loans and to extend credit must be of colossal magnitude if it is to be able to prevent the complete breakdown of our credit machinery. On the other hand, regarded simply as one feature of a plan for strengthening our banking system, a central bank with restricted functions and power can be devised which gives far more certain promise of improvement.

Writing in this Journal for May, 1909, I pointed out at some length that the most serious and, perhaps, insurmountable obstacle to the successful working of a central bank in this country is found in the employ-

ment in normal times of even a part of the vast lending power which was an essential feature of all the plans for such an institution which had been brought forward. Nor has this difficulty been overcome in any of the proposals which have subsequently appeared. Further reflection, however, has led me to the conclusion that a central bank is feasible for this country; but only upon two conditions. In the first place, the adoption of measures designed to strengthen the other banks is necessary in order to diminish the strain upon the central bank and consequently the need of granting it the colossal lending power which will otherwise be indispensable. In the second place, it must be generally recognized that it is not the primary function of a central bank to strengthen our system by means of the advances which it may make to other banks. Through a central bank the machinery can be provided which will prevent the scramble between the banks to strengthen themselves in emergencies and which will also greatly diminish the withdrawals of cash by individual depositors except from banks whose solvency is in question. If this can be accomplished it would never be necessary for a central bank to make large advances to the other banks. Its lending function would be distinctly secondary and its power to extend credit could be limited to such comparatively small proportions that the difficulty of handling its loan account in normal times would not be of serious moment. But to most of those who are favorably inclined towards the central bank proposal much of its attractiveness is found in the improvements in our credit arrangements which are expected from its lending operations. Moreover, the view that a central bank with extensive lending power cannot be made to fit into our system has been con-

troverted by high authority [1] and the conclusion that this view is without real foundation has gained wide acceptance. For these reasons it seems advisable to give some further consideration to the matter before introducing the particular proposal which is the main concern of this article.

Foreign example, tho helpful, must be followed with extreme caution on account of some fundamental peculiarities in our banking organization and practice. The power of banks to extend credit in the form of deposits is restricted in all countries having a central bank, with the single exception of England, on account of the limited use of checks. Consequently when a given amount of accommodation is secured from the central bank the other banks are not able to make very much more than an equivalent increase in their own loans. The effect of advances made by the Bank of England is far more considerable. Upon the notes of the Bank as till money and upon balances at the Bank as reserves rests the vast deposit credit structure of the other banks. Except when the proceeds of loans are being used to meet foreign obligations or payments to the government, advances by the Bank of England serve to increase, tho indirectly, the foundation upon which the other banks extend credit in the form of deposits to several times their amount.[2] The lending operations of the Bank do not, however, result in dangerous credit expansion because its power to extend loans is not great, and even that limited power is exercised with great caution. It is unable to extend credit in the form of notes, since its note is

[1] See Paul M Warburg's A United Reserve Bank of the United States, pp 32–42.

[2] The process is indirect because the other banks do not rediscount at the Bank of England. It is the withdrawal of money lent to bill brokers, who in turn are obliged to borrow from the Bank, which serves to increase bankers' balances at the central institution.

virtually a gold certificate; and tho its deposit credits have the same effect upon the lending power of the other banks, the general economic and financial position of the London money market seldom permits of their rapid increase. A large amount of foreign money is regularly employed there, and any considerable increase in the loans of the Bank would at once depress rates and induce the withdrawal of foreign lenders.

In the United States the expansive effect upon the volume of credit of the advances made by a central bank, whether in the form of notes or deposits, would be similar in kind to that noted in the case of the Bank of England. But the difficulties to be met would be far more unmanageable. It is agreed upon all hands that there is no likelihood of securing favorable action upon a plan for a central bank if it is to compete in any substantial way with existing banks. Its loans are to be made to the other banks either in the form of notes, which, unlike those of the Bank of England, are to be credit instruments; or in the form of deposits on its books. Both its notes and deposits would be considered (and necessarily so if the bank is to be able to handle emergencies) as reserves by the other banks. Upon these reserves they would without much doubt build up deposit credits to the extent permitted by law or, in the absence of legal limitation, to such limits as might be deemed safe by the officers of the individual banks.

It is contended, however, that the danger of excessive credit expansion resulting from the operations of a central bank would be slight because the Bank would rediscount only paper of the very highest quality, and that it would be overcome entirely by means of a sliding scale of discount. But the character of the security which will be acceptable will not appreciably

affect the situation one way or the other. Practically all banks have some paper which would meet the most exacting of tests. The root of the difficulty is found in the use which will be made of the additional lending power thus secured by the other banks. While in some instances this power might be used to make further loans of the same high character, there is quite as great a possibility of its employment in underwriting syndicates or in collateral loans to customers the proceeds of which will be used for speculative purposes.

The effectiveness of a sliding rate of discount in preventing undue credit expansion is also far from certain. Where, as in England, foreign financial dealings are large relatively to those of purely domestic origin, the course of the foreign exchanges is a delicate barometer of the credit position, and it is a comparatively easy matter for the officers of central banks to adjust their rates to meet changing circumstances. In the United States the credit furnished by the banks is almost entirely utilized for domestic purposes. Excessive credit expansion is but remotely reflected in the market for foreign exchange. It would, therefore, be unusually difficult for the central bank to adjust its rates so as to promote business activity when that would be of general advantage and to exercise restraint when that becomes necessary.

But there is a far more serious obstacle to successful results from a sliding scale of discount. Partly on account of the differences in the average quality of loans but mainly on account of the absence of branch banking, there is a wide difference in lending rates between various sections of the country. If the central bank is to lend everywhere at a rate which would just make it of advantage for the banks of the

eastern money centers to resort to it for discounts, it would be overwhelmed with requests for loans from banks in those sections of the country in which rates are high and an excessive proportion of its funds would be thus absorbed. It might, indeed, lend at different rates in the various sections. But it is extremely unlikely that public opinion would tolerate such differences, especially if the bank were granted a monopoly of issue and held large government deposits. The demand that lending resources be distributed evenly has not occasioned serious difficulty to central banks in other countries,[1] but in the United States there is certain to be such a demand, because owing to the absence of branch banking it would be one of an entirely reasonable nature.

Credit is but imperfectly fluid in a system of numerous independent local banks. Loanable funds flow readily from country banks and those of small cities to the large cities and especially to New York. But with us, unlike the countries with branch banking, the movement goes no further. Our money centers are reservoirs for the collection of funds which cannot be employed either temporarily or permanently at home, but they are unsatisfactory distributing agents. Even tho the demand for loans in its neighborhood is large, the local bank can get little from the money centers beyond what it has deposited or employed there. In England it makes little difference where or to whom the Bank of England makes its advances. Credit may be likened to a reservoir the general level of which is raised or lowered by the loans of the central bank. In this country there are as many reservoirs as there are banks or at least locali-

[1] The agrarian demand for agricultural credits has been the nearest approach in Continental countries

ties. Loans made by a central bank in Boston or Baltimore or even in New York would not enable banks in Seattle or Galveston to lend more freely. In these circumstances a central bank would be obliged to lend in each locality and enormous pressure would be brought to bear to remove any obstacle, such as a discriminating rate of discount, even tho it might be based upon the soundest of banking principles. And in carrying through contraction the management of a central bank would be faced by an even more perplexing problem. It would be necessary to consider the situation in each locality and to apply pressure only where credit had been expanded beyond safe limits and in proportion to the extent of the expansion. Can we expect local opinion to coincide generally with that of the management of a central bank? Often, it is to be feared, aggrieved localities would feel that they were being treated less liberally in the case of expansion and more severely in the case of contraction than neighboring and competing communities.

II

All these difficulties, it will be observed, have a common origin. They will disappear if it can be shown that a central bank can perform its essential functions without that enormous lending power which will bring upon it an irresistible demand for accommodation from other banks in periods of active business. It would then be recognized at the outset that it is not to be primarily a lending institution and that its powers can be so limited as to shield it from unreasonable requirements.

There is a consensus of opinion that the withdrawal and hoarding of cash in emergencies by both individ-

uals and banks has been due not so much to doubt of ultimate solvency as to fear that the banks would temporarily suspend. If this fear can be removed, emergency requirements for cash and the consequent sudden contraction of loans to which the banks have resorted in the past, would no longer be of serious moment. The mere existence of a central bank firmly established in public confidence would largely do away with those temporarily large cash requirements which have proved too heavy a burden for banks. Certainly it would not have been necessary for it to pay out any such quantity of money as would have been needed by existing banks in order to allay distrust in any one of our past crises.

But the diminution in cash withdrawals through the establishment of a central bank is not limited to the general effect of the greater confidence in our banking system which it might create. Through its means more direct influences can be exerted which will so reduce emergency withdrawals that they will become a negligible factor in the working of our credit machinery. This can be accomplished with advantage to the other banks and without involving any loss of liberty in the management of their affairs. The means are very simple: it is only necessary to make the central bank the organ for settlements of clearing house balances in the important cities and also for handling payments and transfers of money between different sections of the country. In other words, its primary function would be that of a clearing house for the entire country with which the other banks would become so closely related in normal times that it would be entirely unlikely that the connection would be severed in emergencies.

The importance attached to this function is the

fundamental novelty in the present central bank proposal. Its significance must therefore receive somewhat detailed exposition.

The ordinary clearing house affords a familiar indication of what may be accomplished through a central bank in economizing the use of money by diminishing the aggregate withdrawals from the banks and by making them more regular in amount from day to day. A clearing house has the immediately practical function of simplifying the daily settlements between the banks of a locality. But its operation has another and even more important result: that of reducing very largely the amount of money required in the conduct of banking, at least in normal times. If, for example, each bank in New York made daily cash settlements with all the other banks of the city singly, it is obvious that a very much larger part of the money holdings of the banks would be in constant use. It might even happen that all the money held by a bank would be paid out in meeting unfavorable balances with some of the banks, tho it might be more than replaced in the course of the day by money received from the remaining banks against which it had favorable balances. Clearly, then, if clearing balances were settled by means of transfers on the books of a central bank instead of with cash there would be a still further economy in its use. This is the London practice; and it reduces materially the amount of coin or notes which would otherwise be withdrawn day by day from the Bank of England. The aggregate balances of the other banks at the Bank of England may remain stationary while wide fluctuations may be of daily occurrence in that of any particular bank. Fluctuating withdrawals of cash are avoided which, even tho temporary, would

make it necessary for the Bank to hold a larger reserve than is now required.

Economizing the use of cash is not, however, the most important result which would follow from the settlement of clearing house balances through a central bank. It would stand ready to make advances when necessary to banks whose reserves had been depleted. The possibility of securing such accommodation would render entirely unnecessary the resort to the issue of clearing house loan certificates in emergencies. Advances by the central bank would be far more effective because they could be made without the delay and inevitable publicity which destroys much of the usefulness of that instrument as an emergency device. Moreover, the working at cross purposes among the banks, which in the absence of provision for the equalization of reserves has always continued after the issue of loan certificates, would be entirely prevented.[1] The central bank would be in position to refuse accomodation to banks seeking to strengthen themselves unnecessarily when well able to meet their obligations with their own cash resources.

It is to be assumed that the central bank, if it is to perform such functions in any adequate fashion, would establish branches in all the important commercial and financial cities of the country. Let it be assumed also that settlement of clearing house balances would generally be made by means of transfers on its books. Then the following results of the first importance would follow. The Bank would be enabled to handle much business by means of deposit

[1] This subject is discussed in the first of the present series of articles, in the February number of this Journal, pp 234–240. It is much more fully treated in the writer's History of Crises under the National Banking System recently published by the National Monetary Commission. See especially references under Clearing House Loan Certificates and Equalization of Reserves in the index.

credits on its books which would otherwise involve the issue of notes or the withdrawal of coin from its reserves. The pressure on the Bank in emergencies would be materially diminished, because it would be in position to insist upon the use of the cash resources of the other banks. This would be a very great gain, especially if means of strengthening the other banks, such as were urged in the two preceding articles, should be adopted. Instead of relieving the other banks of their responsibilities, the central bank, it will be seen, would exert a powerful influence in securing the regular performance of their duties. Finally, the vital cause of weakness which has invariably manifested itself on every occasion of crisis would largely disappear. At such times our banking system has been subjected to intolerable strain because of the wholesale withdrawal by country banks and those of the smaller cities of balances deposited in the banks of the large cities and especially in the banks of New York. Tho unreasoning fear has prompted this action to some extent, the main cause has been the well-grounded belief that the city banks would discontinue currency shipments and temporarily suspend payments. Confidence that payments will be maintained by city banks will certainly do much to reduce withdrawals within limits set by the actual needs of the country banks, and those needs will in turn be greatly lessened if individual depositors acquire confidence in the capacity of the banking system as a whole to meet occasions of severe strain.

There remains for consideration still another means for diminishing and regularizing the movements of cash between banks by means of facilities which can be provided by a central bank. At present many banks are separated by enormous distances from

their reserve agents. When a bank thus situated finds it necessary to increase its cash holdings, either to meet regular requirements, such as those for crop-moving purposes, or in order to be on the safe side in emergencies, it will naturally call for a larger shipment of currency from city banks than there is any great likelihood that it will be obliged to use. The available statistics tho incomplete indicate that very much more money is withdrawn from city banks every autumn than is actually used by the country banks for crop-moving purposes.

This defect in our system can be remedied and at the same time other important advantages gained if the central bank establishes a system for handling the domestic exchanges between all the places in which it has branches, by means of which all payments between banks can be met by transfers on its books. The Reichsbank has perfected a system of this sort which has proved of great advantage, making it possible to make payments throughout the country speedily and at a minimum of expense.[1] The service is open both to banks and to individuals, the only condition being the maintenance of a balance at the Bank the amount of which is determined by the volume of transfers in each particular instance. Whether in case such a system is adopted in this country it should be available for individuals need not be definitely decided at the outset. Until the machinery is perfected it would seem the wiser course to restrict its use to the banks alone. The economy in the use of cash which might be secured in this way is evident. Suppose a bank in Utah were to draw upon its balance

[1] For full details regarding the Giro-verkehr system of the Reichsbank see the volume entitled Miscellaneous Articles on German Banking, pp. 171–213, published by the National Monetary Commission.

in some one of the New York banks. The latter would simply transfer the amount through the central bank to the branch of the central bank in the vicinity of the Utah correspondent. The latter, having its funds in its immediate neighborhood, would only draw them out gradually from day to day as the need arose. Moreover, the central bank would not have to ship funds from New York; even if, like the Bank of England, it were only able to issue a note which is merely a gold certificate, it would still be able to keep a supply of its notes at all of its branches, and from this supply it could pay out anywhere an amount of notes equal to its cash holdings, which would doubtless be largely concentrated in New York. Finally, it may be noted that this system would make it impossible for the reserve-holding city banks to refuse to meet the demands of their banking depositors for funds. The country bank would be able to send a draft on its reserve agent for collection through the central bank and this draft would go through the clearing house in the city where the reserve agent was situated.

Apart from its importance in emergencies a universal system of transfers through a central bank would have important advantages in normal times. The present situation regarding the domestic exchanges is far from satisfactory either to the business community or to the banks. Collections and payments are subject to delay and involve heavy expense, burdensome to most banks tho to some extent shifted upon their customers. Practically the entire expense of the domestic exchanges could be saved. The actual cost to the central bank would be far less than that inevitable under the present system, or lack of system; and such expenses as it would incur would be met by the profits arising from the balances which the other

banks would be obliged to maintain in order to make use of the service. The maintenance of these balances need not be an added expense to the banks, even tho no interest upon them could be allowed. Such balances might properly be included as a part of the required cash reserves of the banks, not merely a part of their reserves which may be deposited with other banks. It seems neither necessary nor desirable to overturn our present system of deposited reserves by taking away a large portion of the funds with which the present reserve-holding banks conduct their business and transferring them to a central bank. Such a great change would make the central bank an institution of unwieldy size and would deprive country banks of all return upon that part of their reserve; and it might lead to a wasteful retention of all their required reserve in the form of cash in their own vaults. The plan proposed would give the central bank a moderate volume of bankers' deposits, leaving the present arrangement unchanged aside from the modifications suggested in the first article of this series.

One further means of improvement remains for consideration. It is closely related to the proposal which has just been discussed, but does not involve any action on the part of a central bank. In a country so large as the United States it would be difficult and perhaps undesirable to establish a system for collection of all checks through a single institution. Tho experience might indicate that such an arrangement was feasible, it would greatly simplify matters at the outset to provide through a central bank only the machinery needed to make transfers between the localities in which it might open branches, leaving to the various clearing houses the task of handling

settlements in their immediate neighborhood. Already a few clearing houses (among which that of Boston is the most important) have in successful operation arrangements for handling checks from surrounding country banks. The cost of collection has been materially reduced; to such an extent that banks can afford to take country checks at par. The average time for collection has also been greatly reduced, with the result, among other advantages, of preventing the vicious practice resorted to by some weak banks of living largely upon the proceeds of collections for which they remit only after much delay. This method of handling country checks seems to have had something to do with the maintenance in New England of regular settlements between banks even during the crisis of 1907. Where such a mechanism is provided, ensuring the steady and automatic presentation and payment of checks and drafts, there is much less likelihood that a bank will resort to delays and evasions as a means of strengthening itself in emergencies than under a regime which allows even in normal times more or less habitual delay.[1]

With our existing banks strengthened in ways such as were suggested in the two preceding articles, and with a central bank in position to insist upon the full use of their resources in handling emergencies, there would be little need of direct assistance from that institution. It should have sufficient lending power to give confidence in the stability of our banking system, but not the enormous strength which would be required if it were to be the entire support of our credit structure in periods of financial strain. In short, according to this plan the management of

[1] On methods of clearing country checks see, in the National Monetary Commission Publications, J. G. Cannon, Clearing Houses, pp. 58–64, 259–276.

the central bank may be likened to the general staff of an army, while the bank itself in the exercise of its powers will be analogous to a reserve rather than an attacking force.

III

It does not come within the scope of this paper to present a detailed plan of organization for a central bank, still less to set forth the legislative restrictions upon its powers or the policy which should be followed by its management. These are matters which may be left for settlement if its primary functions are agreed to be of the kind which has been outlined. Attention will be directed in conclusion to a few matters of special importance or difficulty which should be kept in view in working out the details of a plan for a central bank.

Foreign experience shows very clearly that successful results have been achieved by central banks, differing widely one from another in the details of their organization. In the attainment of the objects in view from the establishment of such an institution, therefore, the determination of the most suitable form of organization for this country, while an occasion for constructive thought of a high order, is, after all, a matter of secondary importance. One thing, however, is essential. Much of the opposition to a central bank of any kind is based upon the fear that it might be controlled and used for selfish purposes by the powerful financial groups which control the large reserve-holding New York banks. This is not a very serious danger under any circumstances, because a central bank is made very nearly immune from such attempts by the publicity which attends its operations and even more by the constant public interest

in its condition and policy. As a positive safeguard, however, the form of organization can without difficulty be made such that the fears of the most distrustful should be allayed. The management might be made entirely independent of the shareholders, as is the case with all central banks except the Bank of England. A part of the directorate might well be appointed by the federal government, tho perhaps not the majority; and certainly not the entire board as is the practice in most countries, the representatives of the shareholders having only an advisory function. The national banks, organized into districts for the purpose, might well be empowered to choose some or even all of the directorate, quite regardless of whether the capital is to be subscribed by them or not. Finally, if the capital is to be furnished by individuals, the shareholders might have the power to choose some number, less than a majority, of the board. All three of these parties in interest might share in determining the composition of the management of the bank. By any one of the means suggested the likelihood of the bank being controlled for selfish purposes, even for a short time, would be practically nil and for any prolonged period an absolute impossibility.

There remains for consideration another safeguard which would in large measure render valueless a successful attempt at gaining control. In Europe, central banks employ their funds mainly in discounts or rediscounts of trade bills, tho they also make (invariably at a higher rate) a moderate amount of advances upon collateral security. In this country, it would probably be found advisable to prohibit entirely the making of collateral loans. Such loans have altogether too much vogue at present, our bankers

greatly exaggerating their liquidness, at least in emergencies. Moreover, in the development of the trade and industry of the country they are of far less importance than the commercial bill. To a very considerable extent they merely enable weak holders to retain a large mass of securities which, if held by persons able to pay for them outright, would do much to strengthen our financial position. Of course, the restriction of the business of the central bank to dealings in commercial paper would not prevent resort to it by banks seeking additional funds to be used in collateral loans, since all banks are certain to have some paper of the commercial variety. But it would simplify matters to a very considerable extent for the management, and would also vastly diminish the utility of the bank to any particular financial group and consequently the temptation to seek a controlling voice in its management.

In recent discussion of the advantages which may be derived from a central bank much has been said of the desirability of domesticating the bank acceptance in this country.[1] It is urged that in its absence the loans of the banks are not and cannot become truly liquid and also that through its use a loan market, as wide as the country, may be developed, so that all borrowers would secure the same rate upon a given grade of security. The proposal is attractive. But it is open to serious objections; and fortunately much of the advantage promised can be secured by other means involving far less danger.

If an acceptance will serve the requirements of a borrower he is far more likely to be accomodated by

[1] National Monetary Commission Publications, The Discount Market of Europe, by Paul M. Warburg, and Bank Acceptances, by L. M Jacobs.

a bank than if it were necessary to grant him a loan. In both instances the bank incurs an obligation. In the case of the acceptance the obligation is entirely contingent upon the inability of the borrower to meet the bill when it matures. In the case of the loan the bank is subject to the same possibility of loss from the failure of the borrower to meet his obligations; but it has also the immediate obligation to supply him with the proceeds of the loan. The use of the bank acceptance involves a danger of excessive credit expansion which is most serious under our system of twenty thousand or more banks. Foreign example affords no indication whatever of what the results might be. In England, with its small number of banks of large average size, this business has been until recently carefully avoided, having been conducted entirely by a small number of accepting houses. On the Continent the acceptance has been in more general use, having been developed at first by private bankers, a very conservative class. Tho from the beginning of their history adopted by incorporated banks also, it must be remembered that the number of such institutions has never been large and that they have been generally of considerable size.

The bank acceptance would seem to be indispensable in connection with the financing of foreign trade; but for purely domestic trade its utility is relatively slight and its use seems to be generally declining. In our foreign trade it might readily be developed by foreign exchange banks, and this may be expected when rates for loans in this country decline to European levels so that it will be profitable to employ our capital for that purpose.

In purely domestic dealings the advantages promised from the use of the bank acceptance can be secured

by other means involving far less risk of excessive credit expansion. Even at present, many borrowers throughout the country secure through note brokers the lowest rates current on commercial loans. These rates, as well as those on commercial loans secured directly from the banks, are unreasonably high judged by foreign standards, inasmuch as they are higher than rates for collateral loans. If it may be assumed that banking profits are not excessive at present, it follows that all that can be expected through the adoption of any change in our credit machinery is a reversal of the relationship between these two classes of loans.[1] This will be accomplished through the central bank if its operations are confined to commercial paper. Indeed, it is the practice of lending at lower rates on trade bills than on collateral loans by the European central banks, rather than the bank acceptance, that gives the former its relatively low rate. Further, it is the preferential treatment of commercial paper which gives it its liquid character in foreign countries. The same policy followed by a central bank here will make the trade bill, whatever its form, a more liquid asset for the banks than the collateral loan and will consequently secure for it a more satisfactory rate.

Most of the plans for a central bank have agreed in assigning to it a capital of something like $100,000,000. But this amount would seem to be excessive for

[1] European bankers might employ temporarily idle funds in our commercial bill market if the bank acceptance were adopted, but the amount of such funds would probably not be large enough to affect appreciably the rate for loans. The wide fluctuations in foreign exchange rates between markets separated by wide distances would be an obstacle. Moreover, it would be extremely hazardous to become dependent upon large amounts of so fluctuating a resource It is not a serious matter in London because in addition to its own domestic and foreign trade the foreign trade of other countries is also largely financed there.

a bank of the kind here suggested. A capital of $50,000,000 would be considerably greater than that of any other central bank except that of the Bank of England, whose capital is entirely tied up in the government debt. Dividends upon the shares of the bank should be limited either to a fixed maximum or by turning over to the government a progressively increasing proportion of profits. Even with profits limited in this way, however, a large capital invites the danger of an unnecessary extension of the operations of the bank in order to earn a moderate return to shareholders.

Experience shows very conclusively that it is unwise to hamper a central bank with restrictions upon the extent to which it may extend its credits either in the form of notes or deposits. Presumably a central bank in this country would find it desirable to maintain in normal times a specie reserve of at least 50 per cent against its demand liabilities, but it should feel no hesitation in, and certainly should not be prevented by law from, going as far below that proportion as might be necessary in handling emergencies. But legislative provisions, which without limiting the possible amount would impede somewhat the issue of its notes, might serve the useful purpose of shielding the bank from unreasonable demands for accomodation. No advantage is to be gained through an increase in the amount of paper substitutes for coin so long as the present undesirably large increase in the gold supply of the world continues. Both monetary and banking requirements would seem to be best served by granting the bank the right, free from taxation, to issue an amount of notes equal to its gold holdings, while all additional issues upon which there would be no definite limit might be sub-

ject to a tax of at least 5 per cent. The issue of taxable notes need not be regarded as in any way an emergency measure. The tax would restrain the management somewhat but its primary purpose would be to shelter the Bank from the criticism of over-sanguine citizens unable to perceive in periods of active business the wisdom of a refusal to extend credit to the extreme limits of safety.

In addition to the funds subscribed by its shareholders the Bank would also secure funds deposited by the other banks to enable them to make use of its exchange and clearing service, and also the funds constituting the working balance of the United States Treasury. It might, too, secure a still further accession of funds, and at the same time relieve the government of a portion of its monetary burdens, if the issue of gold certificates were discontinued and the present certificates redeemed. On account of the preference of the people for paper money much of the gold thus paid out would certainly be taken to the central bank to be exchanged for its notes. This gold would largely augment the general banking reserve of the Bank since it would not be held as a special deposit against the notes.[1] At the same time the $346,000,000 of greenbacks might also be exchanged for the notes of the Bank, the $150,000,000 gold reserve being turned into its general reserve. As a result of these arrangements two kinds of money now in general use would disappear from circulation, the gold certificate and the United States note, and would be replaced by the notes of the central bank. The government would

[1] Much of the strength of the Bank of France is to be attributed to this preference for paper money. The stock of money in circulation has increased in France with the growth of population and business, and on account of the increase in the world's supply of gold This gold, instead of going directly into circulation, has been largely taken to the Bank of France to be exchanged for bank notes.

cease to be responsible for any kind of paper except the silver certificates. The amount of these, however, is far less than is always required for monetary purposes outside the banks and they no longer present a serious monetary problem. They might, indeed, be taken over by the bank in exchange for its notes. The reserve of the bank would then be composed in part of silver; but in this respect it would not be unlike some very successful central banks, notably those of France and Germany. At the outset, however, it might well prove the wiser policy not to weaken the prestige of the bank in this way. By reserving for the silver certificate the one-dollar and two-dollar denominations, and by restricting the volume of bank notes of the next two denominations, sufficient use would be provided for the existing volume of silver certificates, the position of which would then be somewhat analogous to that of subsidiary coin.

The outcome of these monetary changes will be made somewhat more evident by the construction of a statement of the condition of the Bank just before opening its doors for business. Most of its liabilities can be stated with some certainty: viz. capital $50,000,000; U. S. notes $346,000,000; U. S. Treasury account (taking its present condition as a basis) $160,000,000,[1] and, finally, the deposits of bankers for clearing and exchange purposes, which may be estimated at $75,000,000. The assets of the Bank can be estimated less exactly, because of the impossibility of knowing the proportion of the different kinds of money now in circulation which would be turned into the Bank. Subscription to its capital

[1] I have not included in this statement the item of $36,000,000 of U. S. deposits now held by the national banks. Presumably, much of this amount would be transferred to the central bank, tho perhaps not at the outset.

might reasonably be made payable in gold or gold certificates. Upon assuming responsibility for U. S. notes, the Bank would receive the $150,000,000 gold reserve. The remaining $196,000,000 might perhaps be taken care of by assigning a government debt to the Bank which, as in the case of the Bank of England, would be a book debt not subject to sale. This obligation need not involve any interest charge on the government. Even if interest were paid, it would be a matter of no special importance, in view of the limitation of dividend to be paid to shareholders. The Treasury balance would give the Bank $95,000,000 in gold and $65,000,000 in other kinds of money made up as follows: $5,000,000 in U. S. notes, about $30,000,000 in bank notes, and a similar amount in silver and subsidiary coin. Assuming that the deposits of the Bank would be made up of $50,000,000 in gold and $25,000,000 in U. S. notes; and cancelling the $30,000,000 of U. S. notes, the statement of condition of the Bank would be as follows: —

Liabilities		*Resources*	
Capital . .	$50,000,000	Gov't debt .	$196,000,000
U.S. notes . . .	316,000,000	Gold	325,000,000
U.S. Treas. account	160,000,000	Silver	30,000,000
Due to other banks	75,000,000	Notes of other banks	30,000,000
	$601,000,000		$601,000,000

The Bank would have a gold reserve of more than 62 per cent of its demand liabilities. Its power to issue notes, however, before reaching the taxable limit would be slight, only $29,000,000. But that would be an advantage from the point of view which has been emphasized in this article. In normal times the rediscounts made by the Bank would probably involve an increase mainly in its deposit liabilities

rather than in the volume of its notes in circulation. Restricted to dealings with other banks there is some doubt whether sufficient business would be regularly secured to enable the Bank to meet expenses and provide a moderate dividend on its shares.[1] Much might be said in favor of a government guaranty of 3 per cent on the $50,000,000 of capital. It would be a small price to pay the Bank for taking over U. S. notes and for handling the receipts and disbursements of the government.

The extent and the rapidity with which the gold holdings of the Bank would be increased through the exchange of gold for its notes cannot be even roughly estimated. It would seem probable that many banks would prefer to hold gold or gold certificates in their reserves rather than the notes of the Bank. On the other hand, gold certificates received in payments to it would be cancelled and either gold or notes paid out according to the preference of customers. Moreover, a considerable portion of future additions to the gold supply would probably be exchanged for notes on account of the preference of the people for a paper circulating medium. This exchange of gold for notes would not increase the power of the Bank to issue untaxed notes but would greatly strengthen its reserve and consequently its ability to extend its operations and to meet any strain upon its resources.

This growth would, in part, be paralleled by that in the number and volume of business of the other banks. Even if ultimately the Bank should attract to itself the means for extending the scope of its operations, that need not be a ground for apprehension.

[1] Idle funds might be employed profitably in the purchase and holding until maturity of foreign commercial bills of exchange. There could be no opposition by the other banks on the ground of competition.

At the outset it would be most important that the Bank should not be overburdened with responsibilities and that the other banks should not rely upon it as the sole support of the credit structure. But when experience had shown that the other banks continued to maintain themselves in a condition of reasonable strength, and that the central bank could secure the use of their resources in emergencies, it might then with safety engage in operations which would have been extremely hazardous at the beginning of its activities.

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